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STUDY BY THE STAFF OF THE U.S.

General Accounting Office

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The Tax Status Of Federal Resale Activities: Issues And Alternatives

There are thousands of resale activities in the Federal Government. The largest, Department of Defense commissaries, exchanges, clubs, and liquor stores, are widespread and big business. Because they are considered Federal instrumentalities, they are exempt from most Federal, State, and local taxes. In 1977 this indirect subsidy (revenue loss) for Defense activities totaled almost \$300 million.

This study discusses the pros and cons of changing the tax status and the effects a change could have on the resale and other activities and on Federal intergovernmental aid programs. It also highlights some alternatives that if implemented would limit the revenue loss.



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Preface

This staff study on the tax status of Federal resale activities is part of GAO's continuing effort to give the Congress information on current issues. This issue is very controversial and complex because it represents an economic benefit to authorized store patrons and involves constitutional immunity from taxation. Adjusting the tax status of these activities requires congressional judgments. Also, some of the alternatives would require congressional action. Therefore, this study provides a framework for examining all the alternatives, including taxation, and as such offers no recommendations.

The first two chapters discuss the

- size of the resale activities (primarily Department of Defense commissaries, exchanges, clubs, and liquor stores); *AGC 00005*
- amount of indirect subsidy (revenue loss) and direct subsidy (Federal appropriations) they receive;
- economic benefits of these activities to their users; and
- reasons they are exempt from Federal, State, and local taxes.

Chapters 3 and 4 discuss the major criticisms and defenses of changing the tax status and the impact a change could have on the activities and on Federal intergovernmental aid programs. The final chapter describes some alternatives that would limit the revenue loss experienced by Federal, State, and local governments. It also discusses how these alternatives could affect the activities, their users, and other Federal policies.

Our analysis relied on GAO reports already issued, reports published by others, and discussions with agency officials. Also, we did not verify information and analyses drawn from non-GAO sources. Where appropriate, we supplemented this information with additional work. Given the complexity of this subject, we urge that other sources be consulted to obtain a full assessment. This staff study is not a formal GAO position statement. It discusses issues and reflects views for which there are no simple answers. However, we believe that it will provide useful information to the Congress.

We obtained informal agency comments on the draft of this study and we included them where appropriate. Additional information on this study can be obtained from Mr. Donald Benedict by calling (202) 275-5743.

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C o n t e n t s

		<u>Page</u>
PREFACE		
CHAPTER		
1	INTRODUCTION	1
	Magnitude of DOD activities	1
	Size of the revenue loss	2
	Importance of the military stores	3
	Other Federal resale activities	5
2	TAX STATUS OF FEDERAL RESALE ACTIVITIES	6
	Federal taxes	7
	State and local taxes	7
3	CHANGING THE TAX STATUS--CRITICISMS AND DEFENSES	10
	Distribution of tax burdens	10
	Occupational disadvantages	15
	Erosion of benefits	16
	Military stores are not what was intended	17
	Tax administration	18
	State and local governments already benefit	21
4	IMPACT ON RESALE ACTIVITIES AND OTHER FEDERAL PROGRAMS	23
	Reduction in sales and profits	23
	Federal impact aid	25
	General revenue sharing	27
5	<i>other</i> SOME ALTERNATIVES THAT COULD LIMIT THE REVENUE LOSS	28
	Alternative I: Making payments to State and local governments	28
	Alternative II: Making stores self-supporting	30
	Alternative III: Charging prevailing prices for those commodities taxed by State and local governments	31
	Alternative IV: Using private/independent contractors to operate resale activities	33

APPENDIX

Page

I	Estimated revenue loss for State sales and cigarette taxes during 1977	35
II	Percentage increase of annual regular military compensation, January 1, 1963, to October 1, 1977	36

ABBREVIATIONS

ACIR	Advisory Commission on Intergovernmental Relations
DOD	Department of Defense
GAO	General Accounting Office
MWR	morale, welfare, and recreation
NASA	National Aeronautics and Space Administration

CHAPTER 1

INTRODUCTION

There are thousands of resale activities operated in the Federal Government. The largest, and those that are the primary subject of this study, are within the Department of Defense (DOD). Because these activities are considered Federal instrumentalities, they are generally exempt from most Federal, State, and local taxes.

MAGNITUDE OF DOD ACTIVITIES

DOD's largest resale activities, commissaries (grocery stores), exchanges (department stores), clubs (restaurants), and package liquor stores numbered over 2,000 worldwide. The following table shows the approximate number of activities broken down by the United States and overseas.

	<u>United States</u>	<u>Overseas</u>	<u>Total</u>
Exchanges	297	73	370
Commissaries	265	133	398
Clubs/package liquor stores	1,018	497	<u>a/1,515</u>

a/Includes branches.

Exchanges and commissaries ranked seventh among the Nation's top retailing and food stores with approximately \$4.2 billion and \$3.0 billion, respectively, in calendar year 1977 worldwide sales. Club and package liquor store fiscal year 1977 worldwide sales totaled about \$700 million. The following table shows sales broken down by the United States and overseas.

	<u>United States</u>	<u>Overseas</u>	<u>Total</u>
----- (billions) -----			
Exchanges	\$2.8	\$1.4	\$4.2
Commissaries	2.5	.5	3.0
Clubs/package liquor stores	<u>.5</u>	<u>.2</u>	<u>.7</u>
Total	<u>\$5.8</u>	<u>\$2.1</u>	<u>\$7.9</u>

Other DOD resale activities include theaters, bowling alleys, golf courses, hobby shops, and gun clubs. In a 1977 report, we stated that DOD had by far the largest number of activities of any Federal agency, accounting for 98 percent of total assets and revenues. 1/

SIZE OF THE REVENUE LOSS

We did not measure the revenue loss for all Federal, State, and local taxes resulting from DOD's operation of resale activities because of the enormity of such a task. However, we did estimate the revenue loss for certain taxes. The table below shows the revenue loss for each of the major activities during 1977. Appendix I shows the revenue loss by State.

	Federal income <u>tax</u>	State Cigarette <u>tax</u>	Sales <u>tax</u>	<u>Total</u>
	----- (millions) -----			
Commissaries	\$14	\$ 51	\$ 54	\$119
Exchanges	34	51	72	157
Clubs/package liquor stores	<u>5</u>	<u>(a)</u>	<u>17</u>	<u>22</u>
Total	<u>\$53</u>	<u>\$102</u>	<u>\$143</u>	<u>\$298</u>

a/Clubs sell cigarettes. The revenue loss on these items was not calculated because data was not available.

Federal income taxes were estimated on the basis of U.S. sales using the closest fiscal year to calendar year 1977. We used Internal Revenue Service Statistics of Income, 1975 Corporation Income Tax Returns, dated December 1977 to compute the estimated revenue loss. These statistics were the most currently available. If calculated at the higher prices charged in commercial stores, and assuming no change in consumption patterns, the taxes paid would total about \$62 million to \$66 million. We assumed that

1/"Magnitude of Nonappropriated Fund and Related Activities in the Executive Branch" (FPCD-77-28, Apr. 25, 1977), p. iii.

if private/independent contractors operated these stores or these sales were made by commercial stores, the enterprise would have the same profit motives as a corporation.

Cigarette and sales taxes were estimated on the basis of U.S. sales using the closest fiscal year to calendar year 1977. We used 1977 statewide tax rates in calculating the revenue loss. If military shoppers maintained their consumption patterns but bought everything in private stores, they would pay about \$169 million to \$181 million in sales taxes. (See chart on p. 4.)

Many other taxes are not paid by the resale activities. Some of these include (1) State income taxes, (2) local income, sales, and cigarette taxes, and (3) State and local franchise taxes.

IMPORTANCE OF THE MILITARY STORES

The military resale activities (stores) are important for several reasons, not the least of which is that they provide a major economic benefit to authorized patrons (primarily active duty and retired military personnel and their families). The stores sell items to their customers at prices lower than found in private enterprise. For example, studies have shown that commissaries and exchanges offer a price savings ranging from 20 to 22 percent, and about 13 to 20 percent, respectively. We could not find any literature on the price savings from the clubs; however, a DOD directive on pricing liquor store sales indicates that about a 10-percent savings could be expected on liquor purchases. A customer saves an additional 3.5 percent by avoiding State sales taxes. 1/

The estimated range of the total economic benefit in 1977 is as follows:

1/"Appropriated Fund Support for Nonappropriated Fund and Related Activities in the Department of Defense" (FPCD-77-58, Aug. 31, 1977), p. 42.

	<u>Price savings</u>	<u>Sales tax savings (note a)</u>	<u>Total</u>
	------(millions)-----		
Commissaries	<u>b/\$750 to 846</u>	<u>\$ 67 to 72</u>	<u>\$ 817 to 918</u>
Exchanges	<u>b/628 to 1,050</u>	<u>85 to 92</u>	<u>713 to 1,142</u>
Clubs/package liquor stores	<u>c/28 to 28</u>	<u>17 to 17</u>	<u>45 to 45</u>
Total	<u>\$1,406 to 1,924</u>	<u>\$169 to 181</u>	<u>\$1,575 to 2,105</u>

a/Sales tax savings in commissaries and exchanges are based on taxes military shoppers would have paid if they had purchased everything in higher priced commercial stores in the United States. Sales tax savings in clubs and liquor stores are based on actual sales.

b/Based on calendar year 1977 worldwide sales.

c/Based only on liquor store fiscal year 1977 worldwide sales.

One reason for the lower prices is that the stores receive Federal appropriated fund support, valued at about \$532 million in fiscal year 1977. Another reason is the stores' immunity from most other taxes that a private business would pay, such as income, excise, and property taxes. In the private sector, these taxes would normally be passed on to the consumer in the price of goods sold.

The exchanges and package liquor stores, which are morale, welfare, and recreation (MWR), or nonappropriated fund activities, are also important from another aspect. Their profits support the operation of other recreational and social service MWR activities. A large part of the package liquor store profits supports many of the clubs, which also are nonappropriated fund or MWR activities.

Unlike other MWR activities, commissaries are appropriated fund activities. They sell food and other items at cost plus a surcharge. The surcharge covers the cost of certain commercial transportation, operating equipment, construction, supplies, utilities, and merchandise losses and spoilage.

OTHER FEDERAL RESALE ACTIVITIES

Many smaller resale activities operated in 32 other Federal agencies contribute to the morale and welfare of Government personnel. ^{1/} Except for the U.S. Coast Guard, the activities in the other agencies do not offer the complete line of goods and services offered by DOD activities.

Some of the other activities and revenues are as follows.

<u>Organization</u>	<u>Activity</u>	Revenues (note a) (millions)
U.S. Coast Guard	Exchanges, commissaries, clubs, and package liquor stores	\$71.1
National Aeronautics and Space Administration (NASA)	Exchanges, cafeterias, and vending machines	\$ 3.8
U.S. Postal Service (Employee Welfare Committees)	Cafeterias and vending machines	\$10.4

^{a/}Primarily 1975 revenues.

We obtained information on the tax status of these activities from agency officials. Their tax status, along with that of DOD resale activities, is discussed in the next chapter.

^{1/}"Magnitude of Nonappropriated Fund and Related Activities in the Executive Branch" (FPCD-77-28, Apr. 25, 1977), pp. iii to v.

CHAPTER 2

TAX STATUS OF FEDERAL RESALE ACTIVITIES

The tax status of Federal resale activities depends on each activity's legal status, how each is operated, and the type of tax in question. The chart below summarizes the tax status of the activities.

Organization (activity) (note a)	<u>Federal</u>		<u>State and local</u>		
	<u>Income</u>	<u>Excise</u>	<u>Income</u>	<u>Sales</u>	<u>Excise</u>
DOD (commissaries, exchanges, clubs, and liquor stores) (note b)	Exempt	Indirectly taxable (note c)	Exempt	Exempt	Mostly exempt (note d)
U.S. Coast Guard (commissaries, exchanges, clubs, and liquor stores) (note b)	Exempt	Indirectly taxable	Exempt	Exempt	Mostly exempt (note d)
NASA (exchanges, cafeterias, and vending machines) (note b)	Exempt	Indirectly taxable	Exempt	Exempt	Indirectly taxable (note e)
U.S. Postal Service (cafeterias and vending machines) (note b)	Taxable	Indirectly taxable	Taxable	Taxable	Indirectly taxable (note f)

a/These activities are considered Federal instrumentalities.

b/DOD, Coast Guard, and NASA use concessionaires or private/independent contractors to some extent to operate their resale activities. The Postal Service relies entirely on private/independent contractors. We did not determine the extent of contractor operations in all these organizations; however, when private/independent contractors operate resale activities they are not exempt from income and sales taxes. Any fees received by the activities from contractor operations, however, would still be exempt from income taxes.

c/The armed forces do not pay excise taxes on alcoholic beverages, cigars, and cigarettes shipped to and used by them outside the United States.

d/Motor fuel sold by the activities or through a contractor is subject to State motor fuel taxes. DOD and Coast Guard activities sell tobacco products and alcoholic beverages. Alcoholic beverage taxes are paid in some circumstances. (See p. 8.)

e/NASA activities utilize private/independent contractors for the sale of gasoline and alcoholic beverages; however, some NASA activities sell tobacco products. Those activities that sell tobacco products pay the State excise taxes because the tax is not on the instrumentality.

f/Tobacco products are sold by private/independent contractors in vending machines. Private contractors are required to pay all Federal, State, and local taxes.

FEDERAL TAXES

Because the activities have the legal status of Federal instrumentalities, they are entitled to the same exemptions as the Federal Government and are not subject to Federal income taxes. However, the Federal Government's instrumentalities and resale activities indirectly pay Federal excise taxes on motor fuel, beer, wine, distilled spirits, cigars, and cigarettes for use in the United States. These taxes are paid indirectly because they are imposed on the manufacturer or producer and are included in the cost of goods sold by the activities.

STATE AND LOCAL TAXES

As early as 1825 the Congress authorized the Army to sell food and other items at cost to officers at certain frontier posts. In later years this authority was expanded to include enlisted personnel and the other services. Thus commissaries are an integral part of the services. DOD's other resale activities, some of which have been in existence for over a century, were created by Department regulations as Federal instrumentalities. Legal decisions, including those of the U.S. Supreme Court, have determined that these activities are governmental in nature and thus they have all the constitutional immunities from State and local taxation enjoyed by the Federal Government. ^{1/} Additionally, these stores are generally located in areas of exclusive Federal jurisdiction under which the Constitution precludes the application of State and local tax laws to transactions conducted in these areas, except to the extent waived by Federal statutes.

Frequently, States have exempted suppliers from cigarette and alcoholic beverage taxes on goods sold to resale activities. One very practical reason for these exemptions is to encourage the Federal Government to do business within the State, because without them the activities could purchase these commodities outside the State and ship them into the State. In such a situation the State to which the activity ships cannot impose an excise tax on the Federal Government because of its immunity. Whether the tax of the State the activities purchase from is paid depends upon the nature of the tax and whether it falls upon the resale activity or the supplier. If the tax does not fall on the

^{1/}"The Legal Status of Nonappropriated Fund Instrumentalities and Their Employees," DOD Management Study Group, Washington, D.C., July 1975, pp. IV-1 and VIII-11.

activity and there is no legislative language or intent that the tax be passed on to the purchaser, the activities would pay the tax indirectly. We understand that purchases of alcoholic beverages within States that do not grant an exemption to suppliers occur only in some circumstances when it is more advantageous--price, convenience, and quantity factors being considered--to buy within those States. Finally, in some States that control the import and sale of alcoholic beverages the resale activities do pay a markup.

Federal instrumentalities are immune from State and local taxes unless the Congress specifically authorizes such taxes. ^{1/} For example, in 1936 the Congress passed the Hayden-Cartwright Act (4 U.S.C. 104), which permitted State taxation on motor fuel sold by or through Federal instrumentalities for personal use.

*Shepard
p 10*

Q06 BUCK RESOLUTION (STATE TAXES - FEDERAL TAXES)

In 1940 the Congress passed the Buck Act (4 U.S.C. 105-110), which allowed State and local income and sales taxes to be collected from private persons, commercial activities, private/independent contractors, and concessionaires doing business in exclusive Federal jurisdiction areas. This act requires that private/independent contractors or concessionaires doing business in Federal areas must pay income taxes and collect sales taxes, which are levied on, with respect to, or measured by sales, receipts from sales, purchases, storage, or use of tangible personal property.

The Buck Act did not waive the immunity of the Federal Government and its instrumentalities from State and local taxation. It also did not allow State and local sales or use taxes to be collected from authorized store patrons and gave the service Secretaries the authority to designate authorized purchasers. These immunities were not waived because the services contended that resale activities should be exempt from State taxation. Some of the arguments given by the services included:

- Taxes would interfere with essential Federal functions.
- Taxes would hurt the low-paid military member.

^{1/}"Immunity of Military Exchanges From Federal, State, and Local Taxes" John J. Brauch, Judge Advocate General Law Review, Mar. and Apr. 1967, p. 23.

--Morale would be adversely affected.

--The military provides all the public services needed by the base; thus there is no logical basis for extending taxes to military stores.

The next chapter discusses the pros and cons of changing the sales and excise tax status of military stores and their authorized patrons.

CHAPTER 3

CHANGING THE TAX STATUS--CRITICISMS AND DEFENSES

The major criticisms and defenses of changing the tax status are as follows:

- † --Taxation would promote a fairer distribution of tax burdens.
- --Taxation would not be equitable because the disadvantages of military service justify this special treatment.
- --Taxation would be viewed as an erosion of military benefits.
- † --Taxation is justified because the stores now operating are not what was intended by the Congress.
- † --Taxation promotes effective tax administration.
prevent tax evasion on alcohol, tobacco
- --State and local governments already benefit from the military installations; therefore, no additional taxes are warranted.

DISTRIBUTION OF TAX BURDENS

The proponents of taxation believe that eliminating the tax exemption of on-base sales to active duty and retired military personnel would promote a fairer distribution of tax burdens because

- military and civilian compensation is similar, thus military personnel are no less able to bear the burden of State and local taxes than their civilian counterparts, and
- many military personnel are no longer segregated from society and thus they consume public services roughly similar to their civilian counterparts.

Military compensation is similar
to civilian compensation

Military compensation has risen dramatically in recent years. For example, from 1963 to 1977 (see app. II) military personnel received regular military compensation 1/ increases ranging from 135 to 242 percent.

Many military compensation studies have been conducted. Although there is no absolute measure of what military compensation should be, the information contained in these studies indicates that military compensation is similar to private compensation.

A Rand Corporation study 2/ performed for DOD showed that enlisted careerists received a total compensation (pay and benefits) which fell in the top fourth of income of comparably aged and educated, fully employed, white high school graduates. It also reported that the compensation of the average career officer throughout a 20-year term exceeded the compensation paid to more than 90 percent of comparably aged and educated civilians employed fulltime.

With regard to junior officers and lower ranking enlisted personnel, we stated 3/ that a first lieutenant with 2 years of service had earnings that put him in the top quarter of all U.S. jobholders. Furthermore, many military members in the lower enlisted ranks (E-1 to E-4) and who are in the 18-to-21 age group earn incomes which compare favorably with those of their civilian counterparts. For example, many civilians in this age group are on an hourly

1/"Regular military compensation," the military equivalent of civilian salary, is defined as the combination of basic pay, allowances, and the Federal individual income tax advantage. "Tax advantage" is defined as that amount of money which would have to be added to basic pay and allowances if allowances for housing and meals both in cash and in kind were taxable. For fiscal year 1978 the tax advantage is estimated at about \$1.5 billion.

2/"Military Manpower and the All-Volunteer Force," Richard V. L. Cooper, Rand Corporation, Santa Monica, California, September 1977, pp. 376 to 378.

3/"Need To Better Inform Military Personnel of Compensation Changes" (FPCD-78-27, July 28, 1978), p. 16.

scale, and in 1977 they earned about \$8,000 annually. This is \$1,600 less than the regular military compensation of an E-4 and \$200 less than the regular military compensation of an E-3.

Retiree income

According to the President's Commission on Military Compensation, military retirees receive annuities that compare favorably with those of other retirees. 1/ In addition, the Senate Committee on Appropriations reported on retiree pay. It stated: 2/

"* * * It should be recognized that the average military retiree will receive a stipend in excess of \$7,402 during fiscal year 1978. [3/] Nearly 150,000 retirees receive social security benefits averaging \$2,405 per year for individuals and \$3,102 per year for families. In addition, over 140,000 retirees hold 'second career' jobs in Federal employment. In some cases, the total compensation received by the individual exceeds \$70,000 per year (Civil Service pay and retirement). * * *"

Further, it stated:

"* * * It [DOD] confirmed the committee's view that there are few retirees who are living on extremely low incomes. In fact, only 107,000 have adjusted gross incomes of less than \$6,000, and it is very likely that many of these individuals receive social security benefits in the amounts discussed above, which tends to increase their total disposable income substantially since social security is not taxable. * * *"

1/"Report of the President's Commission on Military Compensation," Washington, D.C., April 1978, pp. 28 to 31.

2/"Department of Defense Appropriation Bill 1978," Senate Committee on Appropriations, Report No. 95-325, U.S. Senate, 95th Congress, first session, Washington, D.C., July 1, 1977, pp. 39 and 40.

3/In fiscal year 1978 about 1.2 million retirees received estimated total payments exceeding \$9 billion.

Retirement payments are not the only income source of the military retiree. Because many retirees are relatively young, they often have second careers. When combined with the military pension, second career earnings, which range from about \$15,000 to \$21,000 for officers and \$12,000 to \$15,000 for enlisted personnel, led the President's Commission on Military Compensation to conclude that:

"* * * Military retirees often hold civilian jobs in which they earn somewhat less than comparable aged and educated civilians; however, their combined civilian incomes and military retired pay generally exceed the incomes of comparably aged and educated civilians." 1/

Military personnel are no longer segregated from society

In determining whether taxation would promote a fairer distribution of tax burdens another aspect that should be looked at is whether the military receives or uses government services financed by taxes. The proponents of taxation say that, because many military personnel live off base and are no longer segregated from society, they use government services for which they do not share in the tax burdens if they purchase in tax-free stores.

The First Quadrennial Review of Military Compensation, in its 1967 report, stated:

"* * * In an earlier time, the military community was rather sharply segregated from the civilian segment of society. Although the military still retains many of its unique features, on balance it has become a much more integral part of society than it once was."

* * * * *

"Sheer size has caused much of the military population to spill over into the civilian communities adjacent to military bases and to mingle

1/"Report of the President's Commission on Military Compensation," Washington, D.C., April 1978, p. 28.

there with civilians from all walks of life. The traditional isolation of the military has been replaced by new patterns of extensive social integration." 1/

In the past military families lived on base; however, today the situation is much different. As of March 1978 about 500,000, or 67 percent, of the military families stationed in the United States lived off post. These families, plus the approximately 1.2 million retirees who live in the community, require and use the same public services such as schools, roads, police, and fire protection as their civilian counterparts.

The remainder of military families and most of the 750,000 single military stationed in the United States live on base and would not make use of State and local government services to the extent civilians do. Thus, taxation may not promote a fairer distribution of tax burdens because, even though military personnel may have similar incomes, their burdens on government services may not be similar.

The only evidence we could locate that could be used as an argument favoring taxation was contained in a staff study prepared for the Third Quadrennial Review of Military Compensation. 2/ According to that study, 90 percent of commissary sales and 65 percent of exchange sales are made to military families. Also many retirees shop at these stores. This information indicates that the majority of members who use these stores are the same ones who generally live off base and use public services.

Although most of these sales are made to military families, it should be noted that military personnel do pay

1/"Modernizing Military Pay," Report of the First Quadrennial Review of Military Compensation, Office of the Secretary of Defense, Washington, D.C., Nov. 1, 1967, pp. 6 and 7.

2/"Military Equivalent Salary," Third Quadrennial Review of Military Compensation, Staff Research Papers, Office of the Secretary of Defense, Washington, D.C., July 17, 1976, vol. I, p. 29.

State and local taxes on off-base purchases and real property taxes either directly on their residences or indirectly in the form of rent and in some instances they may pay taxes on purchases made on the base. Also, because the base offers many services such as recreational activities, libraries, and other social and welfare activities, a military family's burden on government services may not be exactly similar if they use these services.

OCCUPATIONAL DISADVANTAGES

Measuring whether taxation would promote a fairer distribution of tax burdens based on income levels and use of government services alone is only the first step toward achieving overall fairness. In the case of military members, there are disadvantages that they must endure such as loss of personal freedoms, directed moves, family separation, injury, and loss of life. ^{1/} The opponents of taxation argue that these and other differences make the compensation and taxes paid by military personnel difficult to compare to civilian workers because they address social and psychological issues which are unquantifiable.

Probably the most unique disadvantage common to all military members is the loss of personal freedom. Once an individual accepts the commitment of military service, he/she relinquishes many freedoms. For example, military members cannot quit until after their initial commitments have expired, and they have no right to unionize.

Directed moves and family separation are also disadvantages. According to one staff study, ^{2/} an average careerist moves 9 times in a 22-year service period and there are about 2.5 years of extended family separation. In addition, a careerist experiences about 2 years of nonextended family separation for such things as field exercises. Directed moves are not always a disadvantage

^{1/}For a detailed discussion of all the disadvantages of military service, see "The Military Factor," Third Quadrennial Review of Military Compensation, Staff Research Papers, Office of the Secretary of Defense, Washington, D.C., December 1976, vol. V.

^{2/}"The Military Factor," Third Quadrennial Review of Military Compensation, Staff Research Papers, Office of the Secretary of Defense, Washington, D.C., Sept. 2, 1976, vol. V, p. 19.

because they provide an opportunity to travel. For example, in a recent survey of officers, DOD estimated that about 52 percent of the officers believed that none of their moves were undesirable and another 32 percent believed that only one or two were undesirable.

Family separation is not as extensive as it once was. For example, at any one time about 87 percent of military families are not separated for extended periods. Nor is this burden unique to the military. For example, technicians and laborers in private industry are employed at remote locations separated from their families for weeks or months at a time.

Injury and loss of life are disadvantages experienced by the military during combat situations. This important disadvantage separates military service from civilian occupations. This disadvantage is also experienced during peacetime primarily among the combat arms branches, which now constitute about 15 percent of the force.

Many advantages of military service at least partially compensate for these disadvantages. ^{1/} For example, military members can receive generous lifetime retirement benefits, veterans benefits, educational assistance, and special pay for hazardous duty.

EROSION OF BENEFITS

We reported in a previous study that service officials and service members view any changes to their compensation as an erosion of their benefits. The term is used to describe any change that may adversely affect the financial status of military members. In this study we stated that total military compensation has not been unjustifiably reduced. We said that this issue is further compounded

^{1/}For a detailed discussion of all military pay and allowances, including special pay and other offsetting compensation benefits, see "Military Compensation Background Papers: Compensation Elements and Related Manpower Cost Items, Their Purpose and Legislative Background," Third Quadrennial Review of Military Compensation, Office of the Secretary of Defense, Washington, D.C., August 1976.

by the fact that there is little perception on the part of military members of the real value of total military compensation. 1/

Regardless of the analyses showing that compensation has not been eroded, service personnel believe that it has been. A change in the tax status of military stores would be viewed as a further erosion of benefits, which the services believe would produce a negative impact on morale and motivation and make it even more difficult to recruit and retain qualified individuals.

MILITARY STORES ARE NOT WHAT WAS INTENDED

In past reports 2/ we have discussed the history and justifications for the commissaries and exchanges. Many of the major justifications for these stores (primarily isolation and low pay) are no longer valid. The services believe that these stores, regardless of their original justifications, are still warranted because they (1) generate profits for recreation and welfare activities and (2) are an economic benefit necessary for recruiting and retaining personnel and for fulfilling a moral commitment to retirees.

Our 1975 reports on commissaries stated that these stores were not justified at military installations in metropolitan areas of the United States because enough commercial stores sell food at reasonable prices. We based our conclusion on the original intent for the commissaries, which was to sell food and other items to officers and enlisted personnel at cost at certain frontier posts isolated from civilian retail outlets. This intent was clarified in

1/"Need To Better Inform Military Personnel of Compensation Changes" (FPCD-78-27, July 12, 1978), pp. 5 and 25 to 27.

2/"Information on Commissary Store Operations" (FPCD-75-132, Mar. 19, 1975), pp. 2 and 37.

"The Military Commissary Store: Its Justification and Role in Today's Military Environment" (FPCD-75-88, May 21, 1975), pp. 1 and 6.

"Appropriated Fund Support for Nonappropriated Fund and Related Activities in the Department of Defense" (FPCD-77-58, Aug. 31, 1977), pp. 4 to 16 and 43 to 44.

subcommittee hearings of the House Armed Services Committee in 1949. At the close of the hearings the Chairman stated:

"The whole theory of the commissary privilege * * * was originally to give it to the people who were at isolated stations who did not have the benefit of metropolitan sales. That is the whole theory and only justification for it. It was never intended that the Government should go in the business of providing for its personnel where they have the privilege and opportunity to go to a private place to buy. It was intended on account of the remoteness of stations to accommodate them."

In our 1977 report on the military stores, we discussed the history and justification of the exchanges. Exchanges were not created by congressional legislation. They started as informal cooperative ventures providing the troops basic necessities and conveniences not available elsewhere. As they grew, regulations were drawn up to control them and they were eventually acknowledged directly or indirectly in legislation.

Our history cited that during one of the first congressional inquiries into the exchanges, the committee had concluded that they were justified solely on basis of isolation and remoteness. This justification was later broadened to recognize that the stores generated funds for morale and welfare activities that as a practical matter were not requested from the Congress. Low pay was also used as a justification; however, we reported that the Congress had corrected this situation in later years.

As mentioned earlier, the services believe the stores are still warranted for various reasons, regardless of their original justifications. Regarding the justification to generate profits for morale and welfare activities, we recommended in our 1977 report that the Congress provide Federal funds for activities such as libraries, athletic fields, tennis courts, and swimming pools at all locations or only at locations where community activities were not available.

TAX ADMINISTRATION

Tax-free cigarette purchases in military stores have been reported in two previous studies to be one source of cigarette bootlegging that has caused the States tax

administration problems. Another potential problem that occurs at the Federal level is when military personnel use the standard sales tax deduction in itemizing expenses on their Federal income tax returns, although they avoid sales taxes on military store purchases.

Cigarette bootlegging

The major source of cigarette tax evasion occurs when cigarettes are illegally transported (bootlegged) from low-tax States to high-tax States. There are two types of smuggling: (1) organized purchasing, done for lucrative profits, and (2) casual purchasing for friends and neighbors.

Another source of cigarette tax evasion comes primarily from casual purchases of cigarettes from tax-free outlets, such as military stores. In a 1976 Law Enforcement Assistance Administration study on cigarette smuggling, the staff reported:

"* * * Most such purchases are small-scale, on the order of a few cartons for consumption by military personnel and their families, but are also purchased for friends. Although most individual violations are minor, in some States the aggregate violations constitute a serious problem. There have also been major abuses of the PX [exchanges] privilege, both by customers and employees of PXs. Cases of cigarettes have been purchased from military PXs for resale to civilian customers. * * *" 1/

The Advisory Commission on Intergovernmental Relations (ACIR) 2/ also reported on this problem. It stated that although it would be unfair to characterize most military persons as "cigarette runners," many military personnel had apparently abused their special tax status by buying

1/"Combatting Cigarette Smuggling," Law Enforcement Assistance Administration, U.S. Department of Justice, Washington, D.C., Jan. 31, 1976, p. 16.

2/ACIR was created by the Congress in 1959 to monitor the operation of the American Federal system and to recommend improvements. It is a permanent national bipartisan body representing the executive and legislative branches of Federal, State, and local governments and the public.

tax-free cigarettes for friends and relatives. It recognized that the military was trying to stop this abuse; however, ACIR believed that it continued to represent a significant problem to some States. 1/

Sales tax deductions on
Federal income tax returns

Since 1960 the Internal Revenue Service has prepared tables of sales tax deductions for taxpayers in States with general sales tax laws. The table gives taxpayers an easy way to claim sales tax deductions as an alternative to keeping detailed records.

The table is developed through an analysis of consumer expenditures for such items as food for home consumption, restaurant meals, alcoholic beverages, tobacco, and clothing. All these items can be purchased in military stores free of sales taxes. Thus, when members use the stores and itemize on their Federal income tax returns by using the table, they are receiving an additional tax break. Use of the table allows a deduction for sales taxes not paid and results in a lesser amount of income taxes. 2/ There is no way to determine the amount of revenue lost because (1) a person using the table does not have to keep detailed records, (2) correlating specific store users with those who itemize would be extremely difficult, and (3) military personnel do not purchase all their goods in these stores. However, the loss could be significant because the military is not restricted from using the table and there are a large number who itemize (estimated at about 1.4 million). 3/

1/"State Taxation of Military Income and Store Sales,"
Advisory Commission on Intergovernmental Relations,
Washington, D.C., July 1976, pp. 13 and 17.

2/This could also affect State income tax liabilities in those States where itemized deductions are based on Federal returns.

3/The number of active duty members who itemize was calculated by us to be about 560,000 based on DOD estimates of the percent itemizing contained in the Third Quadrennial Review of Military Compensation. The number of retirees who itemize was calculated by us to be about 831,000 based on DOD estimates of home ownership contained in the Military Retiree Survey Report and Internal Revenue Service Statistics of Income showing percent of itemized returns claiming real estate tax deductions.

STATE AND LOCAL GOVERNMENTS ALREADY BENEFIT

It can be argued that any additional taxes on military store sales are unwarranted because State and local governments already benefit from the presence of military installations through stimulation of economic activity, which leads to creation of more tax revenues. Although this is generally true, it is also true that the Federal presence also produces increases in the need for financing government services and in some instances has precluded private development which would have given rise to sizable local revenues.

Probably the most significant benefit to a local economy is Defense expenditures for goods and services and payrolls for military and civilian personnel. For example, according to one study 1/ on a regional economy heavily impacted by the military presence, expenditures and payrolls were reported to total about \$1 billion and \$2 billion, respectively, in 1975. Other benefits include Federal impact aid funds 2/ and increased employment in service sectors, such as banking, transportation, real estate, and automobile sales.

Not all DOD procurement and personnel expenditures benefit a local economy. DOD procures operating supplies, equipment, and even food products primarily through national rather than local outlets. According to the study mentioned previously, local procurement is very low and is commonly limited to perishable items, such as milk, or to local base maintenance supplies and services. Thus, looking at the DOD procurement expenditures for a local area may be misleading because Defense expenditures are often entwined

1/"Summary of National Studies on Nature of Military Impacts," Southeastern Virginia Planning District Commission, Sept. 30, 1976, pp. 1 to 8. This study was based on a review of recent literature received from the President's Economic Adjustment Committee, which is responsible for assessing the impacts of base closings and for aiding communities adversely impacted.

2/School Assistance in Federally Affected Areas (impact aid) (Public Law 81-874) was begun in 1950. One purpose of the program is to minimize the fiscal inequities placed on local school districts for educating children residing on Federal property and/or whose parents are employed on Federal property.

in a subcontracting and interindustry network that may impact other regions more favorably than the region where the military presence is dominant.

Military store purchases also tend to reduce the spending impact of military wages on a local economy. By contrast, an industrial facility employs persons who shop primarily in local retail stores. The previously mentioned study indicated that only about 40 to 50 percent of a base military payroll actually entered a local economy due to the substantial military store purchases. It also indicated that, while per capita spending by military personnel in the local economy is low, civilian salaries earned at a military facility can offset this disadvantage by contributing substantially to the strength and stability of the local economy.

CHAPTER 4

IMPACT ON RESALE ACTIVITIES

AND OTHER FEDERAL PROGRAMS

Military shoppers will have to pay higher prices if the tax status is changed. For example, cigarette and alcoholic beverage taxes would increase prices of these goods if these taxes were passed on to the shoppers as in the private sector. In turn, higher prices could reduce sales and store profits.

Many Federal intergovernmental aid programs have been enacted. While no legislation [program] has been specifically enacted to recognize the stores' and authorized purchasers' exempt status for sales and excise taxes, two programs could potentially be affected. They are the School Assistance in Federally Affected Areas (impact aid) program (Public Law 81-874) and the State and Local Fiscal Assistance Act (general revenue sharing) program (Public Law 92-512).

We are not aware of any studies which estimated the amount of lost sales and profits which would result from a change in the tax status. Also we did not determine the amount of Federal funds that could be saved or redistributed under the intergovernmental aid programs if the tax status were changed. Therefore, the following discussion is limited to the potential impact of a change on the stores and the two programs.

REDUCTION IN SALES AND PROFITS

Reduced sales would probably result from any price increase. While this may occur, an important concern of the services is that sales would shift to the local economy, reducing military store profits or their ability to cover costs.

We could not find any studies that analyzed the impact of taxation on store sales. However, one DOD report estimated that, if most Federal appropriated fund support to commissaries were removed,

--sales would decline by 10 to 26 percent and

--customer savings would range from only 11 to 14 percent below the private sector, down from the 20- to 22-percent savings now offered by the commissaries. 1/

Sales would not decline as drastically if the tax status were changed because the revenue loss is less than the Federal support. For example, commissary appropriated fund support in 1977 was \$314 million, or about triple the revenue loss of \$105 million.

As stated earlier, commissaries sell items at cost plus a surcharge to cover certain expenses. If sales were reduced by imposing taxes, the surcharge might have to be raised to pay for these expenses.

Because exchanges and liquor stores distribute their profits to other MWR activities, any taxes imposed might reduce sales and profits going to MWR activities. This is especially true regarding cigarette and alcoholic beverage taxes. The exchanges sell cigarettes at about 40 cents to 50 cents per pack. This price is only 4 cents to 14 cents below the national average of 54 cents. Because State cigarette taxes range from 2 cents to 21 cents per pack, it is apparent that part of the \$51 million in State excise taxes that are not required to be paid ends up as profits to the exchanges. If exchanges had to pay this tax and wanted to maintain a price advantage over commercial stores, they would have to reduce their profits to cover a portion of the tax. In 1977 the exchanges had a net income of \$139 million. They distributed about \$104 million to recreational activities.

In 1977 the liquor stores had a net profit of about \$51 million, about \$35 million of which was distributed primarily to aid financially ailing clubs. An additional \$13 million was transferred to recreational activities. ACIR said States and localities experienced a revenue loss estimated at \$30 million to \$40 million from the sales of

1/"Commissary and Exchange Benefits," Third Quadrennial Review of Military Compensation Staff Research Paper, Office of the Secretary of Defense, Washington, D.C., Dec. 13, 1975, p. 45.

alcoholic beverages. 1/ If these taxes had to be paid under the present circumstances, the clubs' financial conditions could worsen and the recreational activities would probably lose much of the support received from the liquor stores.

In the above cases the loss of profits that would otherwise be available for recreational activities could result in increased requests for appropriated funds to support these activities. Providing appropriated funds is consistent with our recommendation that the Congress fund many of these recreational activities. (See p. 18.)

FEDERAL IMPACT AID

School Assistance in Federally Affected Areas (impact aid) was initiated in 1950. It is administered by the Office of Education, Department of Health, Education, and Welfare. One purpose of the program is to minimize the fiscal inequities placed on local school districts for educating children residing on Federal property and/or whose parents are employed on Federal property when local revenues, primarily property taxes, are adversely affected by the Federal presence. Today the program is not uniquely confined to the military population. However, it is still identified in part with defense activities. According to one report,

"The Military establishment is also responsible for a congressional bonanza to at least half the nation's school districts * * * The origins of the program lie in Federal support for on-post schools, with occasional aid to civilian school districts * * * The 1940 Lanham Act, which provided substantial compensation for the World War II mobilization impact, was extended year by year until, in 1950, the current 'Impacted Aid' program was born." 2/

Impact aid payments are made for two broad categories of children: "A" children, whose parents live and work on

1/"State Taxation of Military Income and Store Sales," Advisory Commission on Intergovernmental Relations, Washington, D.C., July 1976, p. 13.

2/"The Military Establishment, Its Impacts on American Society," Adam Yarmolinski, Harper and Row, New York, 1971, pp. 40 and 41.

Federal property, and "B" children, who live or whose parents work on Federal property, but not both. The payments are made to local school districts on the basis of an entitlement. The entitlement is expressed as a percentage of a "local contribution rate." This rate can be based on a comparable district's per pupil costs derived from local revenues, which can come from real estate and other taxes or alternatively a minimum rate based on the greater of one half of State or national average per pupil costs.

The entitlement, 100 percent for "A" students and 50 percent for "B" students, varies over several subcategories of children within the broad "A" and "B" classifications. According to one report ^{1/} on impact aid, these subcategories further refine the notion that different types of federally connected children impose differing degrees of burden. For example, the report cited that within the "A" and "B" classifications

"* * * Military children also receive relatively higher entitlements than civilians to compensate for the somewhat greater loss of revenues to a community which may result because military personnel often do business on the base (in military stores) rather than in the community and may be exempt from certain State and local taxes where they are stationed." ^{1/}

According to this study, local school districts also receive a higher payment priority for military children when the program is less than fully funded. For example, a district receives the full 100 percent of the local contribution rate for military "A" children when the program is not fully funded. ^{2/}

Impact Aid

This information indicates that any change in the tax status of military stores for State and local taxes could be argued as a reason to reevaluate the entitlements given for military children. The exact amount of impact aid fund reductions based on a change in the tax status would be difficult to calculate, because financing education costs

^{1/}"Impact Aid Two Years Later," Office of the Assistant Secretary for Planning and Evaluation, Department of Health, Education, and Welfare, Technical Analysis Paper 5, Washington, D.C., Mar. 30, 1978, p. 4.

^{2/}Ibid., pp. 5 to 10.

differ among localities and because impact aid can be granted in various ways. Also, considering the prime reason for impact aid funds--tax-exempt Federal property--reductions may be small in relation to the total program cost, which for fiscal year 1978 is placed at \$770 million.

GENERAL REVENUE SHARING

The State and Local Fiscal Assistance Act (general revenue sharing) program was established in 1972. It is administered by the Office of Revenue Sharing, Department of the Treasury. General revenue sharing represents a new approach to Federal assistance, because under the program recipient governments have broad flexibility in using the funds for what they consider their most vital needs. In fiscal year 1978 Federal assistance under this program totaled about \$7 billion.

The program may be affected if the tax status were changed because a key factor in the formula for Federal funding is based on taxing effort or total taxes collected. Thus if the tax status were changed, total taxes would increase and State and local governments might receive a larger share of general revenue sharing funds. For example, some States would receive more funds whereas others would receive less, depending on which States were more heavily affected by military stores.

A change in the tax status could affect local governments similarly. However, at the local level, there are restrictions to insure that no local government would receive an inordinately large share of funds while another received almost none.

CHAPTER 5

SOME ALTERNATIVES THAT COULD LIMIT THE REVENUE LOSS

The tax status of military stores and authorized purchasers could be changed in various ways. Legislation could be adopted authorizing imposition of certain taxes, such as State and/or local sales, cigarette, or alcoholic beverage excise taxes.

Other alternatives would limit the revenue loss experienced by Federal, State, and local governments. This chapter examines the following alternatives and discusses the benefits as well as the problems of each in relation to the military members, the resale operations, and other Federal policies:

- Making payments to State and local governments.
- Making stores self-supporting.
- Charging prevailing prices for those commodities taxed by State and local governments.
- Using private/independent contractors to operate resale activities.

This study does not recommend a specific alternative because each requires a detailed evaluation. Also none would meet all the needs or resolve all the problems.

ALTERNATIVE I: MAKING PAYMENTS TO STATE AND LOCAL GOVERNMENTS

This alternative would not eliminate any military fringe benefits accruing to active duty and retired members and would not affect the stores. This is not a new idea, and the Federal Government is currently making similar payments. An example is the Federal impact aid program, which minimizes the financial burden placed on local school districts for the cost of educating children of Federal employees. A similar program could provide payments to State and local governments in recognition of burdens placed on these governments for other services, such as police and fire protection of military personnel who reside off base.

The major criticism of such a program would probably be very similar to those that have occurred within the Federal impact aid program. Impact aid has been the subject of much debate and has been studied several times. For example, a 1969 study 1/ found that the program overcompensated many school districts. One reason reported in the study was that the payments did not reflect the economic stimulus Federal activities may bring to a community. While the study found that many districts were overcompensated, it indicated the program was necessary, particularly in small local areas surrounding major military installations where the community could not collect significant tax revenues from either the Federal Government or its employees.

While actions have been taken to correct these problems, a payment program on behalf of military stores might receive similar criticisms because it would be virtually impossible, just as in the impact aid program, to determine the net burden. The 1969 study stated:

"While it is possible to pinpoint extreme cases of overpayments and underpayments to local districts, no formula can ever be developed that precisely calculates payments upon the basis of net economic burden of Federal installations on local schools. This conclusion follows from the fact that there is no reliable way to determine what a community would have been like had the Federal Government never established an installation in it. Existing economic knowledge and present economic data simply do not provide the adequate basis for correct speculation on, for example, the revenue position of Washington, D.C., area schools in the event that the Nation's Capital had remained in Pennsylvania rather than being transferred to Washington, D.C."

Other objections to such a program could include:

1/"School Assistance in Federally Affected Areas, A Study of Public Laws 81-874 and 81-815," Battelle Memorial Institute, Columbus, Ohio, December 1969, pp. VII to IX.

- Because of the impact aid program and because some military members do pay property taxes, either directly or through rents, and do pay some other taxes, such a program could be even more difficult to develop and administer.
- The program would increase Federal spending, including administration costs, in a time of scarce dollars.
- The program would not promote a fairer distribution of tax burdens or solve tax administration problems.

ALTERNATIVE II: MAKING
STORES SELF-SUPPORTING

This concept was reported by the First Quadrennial Review of Military Compensation in 1967. It indicated that the stores were an essential element of convenience and necessity for military families, especially in isolated areas. However, the report said that as military salaries achieved parity with civilian salaries, normally they could fully support the stores without any Federal subsidy. In a 1977 report 1/ we stated that given the improvements in military pay in recent years, which have made it generally competitive with civilian pay, and the availability of similar stores in the private sector, the subsidy should be reduced.

Making the stores self-supporting could lessen the revenue loss. The predominant users are married military and retired members. (See p. 14.) Because most of these people live off base, the probability that they would use these stores would be lessened. This was evidenced in DOD's study (see p. 23) showing that sales and savings would decline if prices were increased.

While there would still be savings, they would not be as great, and individuals who lived off base might view these lesser savings as not warranting a trip to the stores. Thus they would buy from more convenient private stores who collect and/or pay all Federal, State, and local taxes.

Other benefits from this alternative would be:

1/"Appropriated Fund Support for Nonappropriated Fund and Related Activities in the Department of Defense" (FPCD-77-58, Aug. 31, 1977), p. ii.

--More of the burden of taxation would be assumed by the military and retired members who used services in the State or community where they lived.

--The potential tax administration problems could be lessened because the higher prices for goods, such as cigarettes, would discourage casual buying for friends and sales taxes paid at commercial stores would more closely be aligned with Internal Revenue Service tables for sales tax deductions.

This alternative would have a greater impact than changing the tax status. Considering that the Federal appropriated fund support for the stores in 1977 was about \$300 million more than the State revenues lost, the price changes would be larger than the taxes if they were imposed. Also this alternative would be viewed as an erosion of benefits.

ALTERNATIVE III: CHARGING PREVAILING
PRICES FOR THOSE COMMODITIES TAXED
BY STATE AND LOCAL GOVERNMENTS

In 1978 the Veterans Administration announced the following policy on the sale of cigarettes and tobacco products by its canteens. 1/

"As a means of further implementing VA policy on smoking * * * and retain the right of the individual to choose between smoking or not smoking, cigarettes and other tobacco products will continue to be sold in canteens.

"To eliminate the canteen price advantage the sale of all tobacco products will be sold at the prevailing community rates."

While this announcement was primarily made to recognize the adverse health effects of smoking, it does have important implications with regard to lessening the revenue loss on this product experienced by State and local governments. A similar policy could be adopted by DOD for cigarettes sold in commissaries and exchanges. Commissaries

1/The Veterans Canteen Service sells merchandise to veterans, visitors, and employees in Veterans Administration hospitals and homes.

presently sell cigarettes at about 28 cents per pack, 1/ and exchanges sell cigarettes at about 40 cents to 50 cents per pack.

If such a policy were adopted, the States would not experience the revenue loss resulting from bootlegged cigarettes. Also, if cigarettes were sold at prevailing prices, sales probably would drop off. However, because sales would not drop off in direct proportion to the price increase, the stores could experience a net gain.

Commissaries could use this gain to reduce either appropriations or surcharges on food items. Exchanges could use this gain to reduce appropriated fund support or increase the profits distributed to recreational activities. Also, if cigarettes were sold at commercial prices with no increase in other commodity prices, the customer probably would continue to purchase cigarettes in the military stores as a convenience rather than go to a private store which offered no overall price advantage on other commodities.

Regarding alcoholic beverages, a similar policy could be adopted. In a recent report 2/ on alcohol abuse, we indicated that one important factor contributing to alcohol abuse was inexpensive and easily available alcoholic beverages. To simply charge prevailing prices would not eliminate the problem. However, adopting a policy similar to the Veterans Administration's policy on tobacco pricing would be consistent with DOD's effort to combat alcohol abuse. At the same time, such a change could lessen the revenue loss experienced by the States because the military member may only be using the liquor store or the club for its convenience rather than price advantage and might shift to private stores. If purchases do not shift to the private sector, then the revenue loss would not be lessened. In such a case the stores could experience a net gain from higher prices.

A criticism of this alternative might be the erosion of benefits argument. However, considering that the Government knows more today about smoking and health and

1/Only Army and Air Force commissaries sell cigarettes. Price per pack was based on 10-pack cartons, which are sold at about \$2.84.

2/"Alcohol Abuse Is More Prevalent in the Military Than Drug Abuse" (MWD-76-79, Apr. 8, 1976), pp. 24 and 25.

alcohol abuse, it appears contradictory that it should continue to support through lower prices something that is harmful to a member's health and well-being.

Other problems with this alternative are that the

- liquor stores could lose revenues used to fund recreational activities and clubs if military shoppers shift their purchases to private stores and
- purchases in the stores would still be tax exempt and the potential problem with sales tax deductions on Federal income tax returns would not be solved.

ALTERNATIVE IV: USING PRIVATE/INDEPENDENT CONTRACTORS TO OPERATE RESALE ACTIVITIES

Because independent contractors are private parties, they must pay or collect all applicable Federal, State, and local taxes. As a result, military members would have to pay all applicable taxes which would be reflected in the prices of goods sold by contractors.

While this alternative is more drastic than changing the tax exempt status of the stores and their authorized patrons, it would limit the revenue loss experienced by Federal, State, and local governments. Using private/independent contractors would comply with executive branch policy that in a democratic system the Government should not compete with private enterprise. Office of Management and Budget Circular A-76 states this policy and sets down requirements for identifying and systematically reviewing which commercial or industrial activities should or should not be performed by the Government. This alternative would also comply with DOD's directive on funding MWR activities. According to that directive, MWR activities should be contracted out when dictated by the nature of the activities.

The exchanges use private/independent contractors or concessionaires for various service activities, such as barber services, shoe repair, and watch repair. These private parties must collect and/or pay all applicable taxes. According to Senate hearings on DOD's fiscal year 1978 appropriations, Army and Air Force exchanges have over 5,700 personal service activities under contract. 1/ The

1/"Department of Defense Appropriations Fiscal Year 1978," Hearings before the Committee on Appropriations, U.S. Senate, 95th Congress, first session, Washington, D.C., part 3, March 1977, p. 1058.

Marine Corps and Navy exchanges do not use private/independent contractors or concessionaires to the same extent.

A report by the Defense Audit Service on the exchanges recommended that DOD consider having the exchanges operate on a contract basis. 1/ The exchanges disagreed with this recommendation because they believed it would be detrimental to the customer (higher prices after application of taxes) and the stores. Also they believed that contractors would not operate in unprofitable areas and thus Government operation of these stores was necessary to maintain mission effectiveness. This situation could be corrected if unprofitable stores could be packaged with profitable ones for private/independent contract operations. Because using private/independent contractors would have a greater impact than changing the tax status of military stores and their authorized patrons, all the arguments against taxation mentioned earlier would probably be used to criticize this alternative.

1/"Report on the Comparative Evaluation of the Management Policies and Procedures of the Military Exchange Systems," Defense Audit Service, Department of Defense, Arlington, Virginia, July 26, 1978, pp. 6, 47, and 48.

ESTIMATED REVENUE LOSS FOR STATE SALES
AND CIGARETTE TAXES DURING 1977

	<u>Sales tax</u>	<u>Cigarette tax</u>	<u>Total</u>
Alabama	\$ 4,400,490	\$ 2,338,330	\$ 6,738,820
Alaska	(a)	938,736	938,736
Arizona	3,757,374	1,991,640	5,749,014
Arkansas	1,122,580	1,862,101	2,984,681
California	24,774,360	11,855,031	36,629,391
Colorado	3,547,215	2,227,610	5,774,825
Connecticut	973,962	931,380	1,905,342
Delaware	(a)	455,592	455,592
District of Columbia	1,682,426	1,548,139	3,230,565
Florida	7,396,990	10,165,242	17,562,232
Georgia	5,551,214	4,386,231	9,937,445
Hawaii	7,731,676	2,253,097	9,984,773
Idaho	359,851	167,831	527,682
Illinois	4,312,395	2,658,936	6,971,331
Indiana	531,781	299,441	831,222
Iowa	(b)	(b)	(b)
Kansas	1,581,875	1,294,255	2,876,130
Kentucky	2,370,100	580,867	2,950,967
Louisiana	1,261,652	1,731,271	2,992,923
Maine	576,062	686,525	1,262,587
Maryland	3,826,705	2,114,458	5,941,163
Massachusetts	1,151,052	3,677,593	4,828,645
Michigan	789,278	745,801	1,535,079
Minnesota	154,197	326,411	480,608
Mississippi	2,895,625	1,132,520	4,028,145
Missouri	1,592,290	878,378	2,470,668
Montana	(a)	275,003	275,003
Nebraska	644,365	949,084	1,593,449
Nevada	758,291	415,669	1,173,960
New Hampshire	(a)	428,017	428,017
New Jersey	1,255,732	4,356,910	5,612,642
New Mexico	2,282,493	1,177,854	3,460,347
New York	2,377,568	3,815,668	6,193,236
North Carolina	4,414,230	421,345	4,835,575
North Dakota	378,377	425,793	804,170
Ohio	954,245	1,345,069	2,299,314
Oklahoma	1,488,121	1,895,639	3,383,760
Oregon	(a)	69,990	69,990
Pennsylvania	1,659,542	3,128,817	4,788,359
Rhode Island	731,939	917,723	1,649,662
South Carolina	5,657,273	1,225,993	6,883,266
South Dakota	223,712	247,573	471,285
Tennessee	1,290,022	606,916	1,896,938
Texas	16,083,012	14,919,639	31,002,651
Utah	896,416	272,590	1,169,006
Vermont	1,824	9,350	11,174
Virginia	11,273,785	1,499,371	12,773,156
Washington	7,997,532	4,904,172	12,901,704
West Virginia	2,562	2,444	5,006
Wisconsin	224,322	930,529	1,154,851
Wyoming	325,645	132,308	457,953
U.S. total	<u>\$143,262,158</u>	<u>\$101,620,882</u>	<u>\$244,883,040</u>

a/No State sales tax.

b/No military stores.

PERCENTAGE INCREASE OF ANNUAL REGULAR MILITARY
COMPENSATION, JANUARY 1, 1963, TO OCTOBER 1, 1977

		<u>Regular military compensation</u>		
<u>Rank or title</u>		<u>January 1, 1963</u>	<u>October 1, 1977</u>	<u>Percent increase</u>
Officers:				
O-10	General	\$25,102	\$59,060	135
O-9	Lieutenant general	22,477	58,012	158
O-8	Major general	20,568	53,039	158
O-7	Brigadier general	18,294	46,639	155
O-6	Colonel	15,354	40,525	164
O-5	Lieutenant colonel	12,105	32,345	167
O-4	Major	9,727	26,337	171
O-3	Captain	7,902	21,307	170
O-2	First lieutenant	5,953	15,519	161
O-1	Second lieutenant	4,980	12,457	150
Enlisted persons:				
E-9	Sergeant major	7,504	21,165	182
E-8	Master sergeant	6,653	18,021	171
E-7	Sergeant, 1st class	6,219	16,007	157
E-6	Staff sergeant	5,371	13,983	160
E-5	Sergeant	4,454	11,164	151
E-4	Corporal	3,475	9,636	177
E-3	Private, 1st class	2,458	8,220	234
E-2	Private	2,296	7,841	242
E-1	Private	2,263	7,205	218

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